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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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CC:TEGE:EOEG:EO2

PLR-T-103431-15

Date:

May 18, 2016

Attn:

LEGEND

Charity =

Trust =

Dear :

This letter responds to a letter from your authorized representative dated September 18, 2014, and subsequent correspondence, requesting a ruling that the contractual arrangement described below will not generate unrelated business taxable income to Charity. Charity represents the facts as follows.

FACTS

Charity is recognized as a tax-exempt organization described in § 501(c)(3) and classified as a public charity described in §§ 509(a)(1) and 170(b)(1)(A)(vi) of the Internal Revenue Code of 1986, as amended (the "Code"). Charity's primary purpose is to support a particular religious community and its religious, health, social service, and educational institutions. Charity provides financial and administrative support to approximately one hundred and fifty organizations in its region. Charity maintains an endowment through an investment partnership with other tax-exempt organizations. The investment partnership holds a widely diversified portfolio of assets including cash, cash equivalents, domestic and foreign public equities, real estate, domestic and foreign bonds and other fixed income securities, mutual funds, private equity securities, emerging markets, and various other alternative investment classes. Much of the income earned by the endowment fund consists of passive income such as dividends, interest, and capital gains, but some income has been debt-financed or is otherwise treated as unrelated business taxable income under § 512. The investment partnership compensates Charity for indirect services it provides to the investment partnership.

Charity reports this compensation as unrelated business taxable income.

Charity pays out a certain amount of its unrestricted endowment fund each year to fund its operations, creating an “unrestricted annual endowment spending rate.” This annual spending rate is determined according to the factors in the version of the Uniform Prudent Management of Institutional Funds Act enacted in Charity’s state. These include: the duration and preservation of the endowment fund, the purposes of the institution, general economic conditions, possible effects of inflation or deflation, the expected total return from investment, other resources of the institution, and the investment policy of the institution. Each year Charity’s senior managers recommend a spending rate to the Budget and Administration Committee of its Board of Directors. The Committee considers and recommends a rate to the full board which votes to adopt that year’s rate. The spending rate has historically stayed fairly consistent.

Trust is a charitable remainder unitrust described in § 664(d)(2). Under the terms of the trust agreement, Trust’s donor is entitled to an annual payout of a unitrust amount equal to a percentage of the net fair market value of Trust’s assets. See § 664(d)(2)(A). The remainder interest in Trust will be distributed to Charity as the remainder beneficiary.

Charity will become the sole trustee of Trust prior to the exchange for assets for units. In its capacity as trustee, Charity will want Trust to benefit from its diversified and efficient investment and allow Trust to earn a return equal to that realized by endowment fund. To this end, Charity and Trust propose to enable Trust to participate indirectly in the return on Charity’s endowment by entering into an Agreement that will provide for the exchange of Trust assets for units with respect to the endowment. The number of the units assigned to Trust will be based on the value of a unit at the time Trust’s assets are conveyed to Charity. The endowment fund will be unitized so that the value of the unit can be determined at any given time. The value of a unit at any time will equal the net value of the assets in the endowment fund divided by the number of units outstanding at such time. Charity will not reserve or exclude any part of its unrestricted endowment fund earnings from the value of the units. Each unit will give Trust a contractual right to receive periodic payments based on the number of units owned multiplied by the same spending rate that Charity uses, as described above. The contract will provide that Trust can choose to either reinvest part of the periodic payments in additional units, or redeem units, depending on Trust’s cash requirements for meeting its minimum distribution. The value of the units, both at the time of acquisition and redemption, will be based on the value of all underlying investment assets. Any income realized by the endowment fund, but not paid out as part of the annual distributions, and any unrealized appreciation or depreciation in the endowment fund itself, will be reflected in the value of the outstanding units.

Under the contract, Trust will have no ownership interest in the underlying assets of the endowment or the investment partnership, and no contractual rights with respect to other trusts also invested in units with respect to the endowment. All endowment

investments will continue to be made in Charity's name, and for Charity's benefit. Except for the right to review the payout computation, Trust will have no power or right of any kind to control, direct, supervise, recommend or review Charity's business activities, operations, or decisions with respect to the endowment or the investment partnership. Trust will not have the right to veto or opt out of any of the underlying endowment investments. When Charity makes decisions regarding the endowment investments, it will not be acting in its capacity as trustee of Trust. The contract will provide that, with respect to the issuance of units, Charity is neither a partner nor an agent of Trust. Trust will not be or become liable for any cost, expense, or payment incurred or due by Charity, or for which Charity is liable or responsible relating to the endowment (or its interest in the investment partnership and its assets) other than bearing its allocable portion of the costs of management as described below. Charity will indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by Charity with respect to the endowment (or the underlying assets). Charity will pay any tax owed on unrelated business taxable income earned by the endowment's portfolio.

Charity represents that it will not assess a fee for managing and administering its endowment fund; however, it expects to recover its actual costs of managing the endowment, including the actual costs of management of Trust assets, as a charge against the total investment return of the endowment. These costs will decrease the value of Trust's units.

LAW AND ANALYSIS

Section 501(c)(3) of the Code describes as exempt from federal income tax entities organized and operated exclusively for charitable, educational, scientific, and certain other purposes.

Section 511(a) imposes a tax on the unrelated business taxable income of organizations described in § 501(c)(3) of the Code.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in § 512(b).

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) provides that the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 664(d)(2) defines a charitable remainder unitrust, as a trust (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals; (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in § 170(c); (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use; and (D) with respect to each contribution of property to the trust, the value (determined under § 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Section 1.513-1(a) of the Income Tax Regulations (“regulations”) includes gross income of an exempt organization subject to the tax imposed by § 511 in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization’s performance of its exempt functions.

Section 1.513-1(b) provides that for purposes of § 513 the term “trade or business” has the same meaning it has in § 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) provides that in determining whether a trade or business from which a particular amount of gross income derives is “regularly carried on” within the meaning of § 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(1) provides that, in general, gross income derives from an “unrelated trade or business,” within the meaning of § 513(a) if the conduct of the trade or business which produces the income is not substantially related (other than through the

production of funds) to the purposes for which exemption is granted. This requirement necessitates an examination of the relationship between the business activities which generate the particular income in question — the activities of producing and distributing the goods or performing the services involved — and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) provides that a trade or business is “related” to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income), and is “substantially related” for purposes of § 513, only if the causal relationship is a substantial one. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under § 501(c)(3). The organization received funds from unrelated exempt organizations and invested the proceeds in stocks, reinvested the income and realized appreciation, and upon request, liquidated participant's interests and distributed the proceeds to the participant. The Service held that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The Service further held that the activity would constitute an unrelated trade or business even if the services were regularly provided by one tax-exempt organization for other tax-exempt organizations. Thus, the Service concluded that the organization was not tax exempt under § 501(c)(3) because it was regularly carrying on a business of providing investment services that would be an unrelated trade or business if carried on by any of the tax-exempt organizations on whose behalf it operated.

Under § 511(a)(1) and (2) an organization described in § 501(c)(3) is subject to the tax imposed by § 511 on its unrelated business taxable income (as defined in § 512.) Generally, § 1.513-1(a) provides that gross income of an exempt organization is includible in the computation of unrelated business taxable income if: (1) is it income from trade or business; (2) such trade or business is regularly carried on; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

The term trade or business has the same meaning for purposes of § 513 as it does for § 162, “and generally includes any activity carried on for the production of income from the sale of goods or performance of services.” Section 1.513-1(b). Charity has represented that it will not charge a fee for the investment services it provides to Trust, although Trust will indirectly bear its portion of the costs that Charity incurs in administering the endowment. Charity is not pursuing income by providing to services to Trust by issuing units, making and receiving payments with respect to the units and redeeming units.

Charity's situation is also distinguishable from the entity in Rev. Rul. 69-528 that provided investment services on a regular basis for a fee. The IRS held that activity to be a trade or business carried on for profit, and found that it was unrelated to the entity's exempt purpose because the services were provided to unrelated organizations, even though the services were regularly provided by one tax-exempt organization for the benefit of other tax-exempt organizations. Charity represents that it will not charge any fees for the investment services it provides to Trust. Rather, Charity will only recover the actual costs of managing its endowment fund.

Therefore, Charity's services provided under the contractual arrangement, as represented, will not arise to a trade or business within the meaning of § 513, and will not generate unrelated business taxable income.

CONCLUSION

Based solely on the facts and representations submitted, we rule that the contractual arrangement described herein, under which the Charity will issue units to the Trust in exchange for assets of the Trust, make payments on the units, and receive payments to cover costs allocable to the management of the Trust assets, will not generate unrelated business taxable income to Charity.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an individual with authority to bind the taxpayer. This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination.

No ruling is granted as to whether Charity qualifies as an organization described in § 501(c) and, except as expressly provided above, no opinion is expressed or implied concerning the federal income tax consequences of any other aspects of any transaction or item of income set forth in the ruling letter.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Andrew F. Megosh, Jr.
Senior Tax Law Specialist
Branch 2
(Tax Exempt & Government Entities)

cc: